

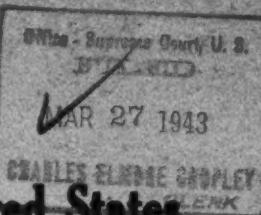
(16)

IN THE

Supreme Court of the United States

October Term, 1942

No. 857....



THE FRANC STONE COMPANY,

Petitioner,

v.s.

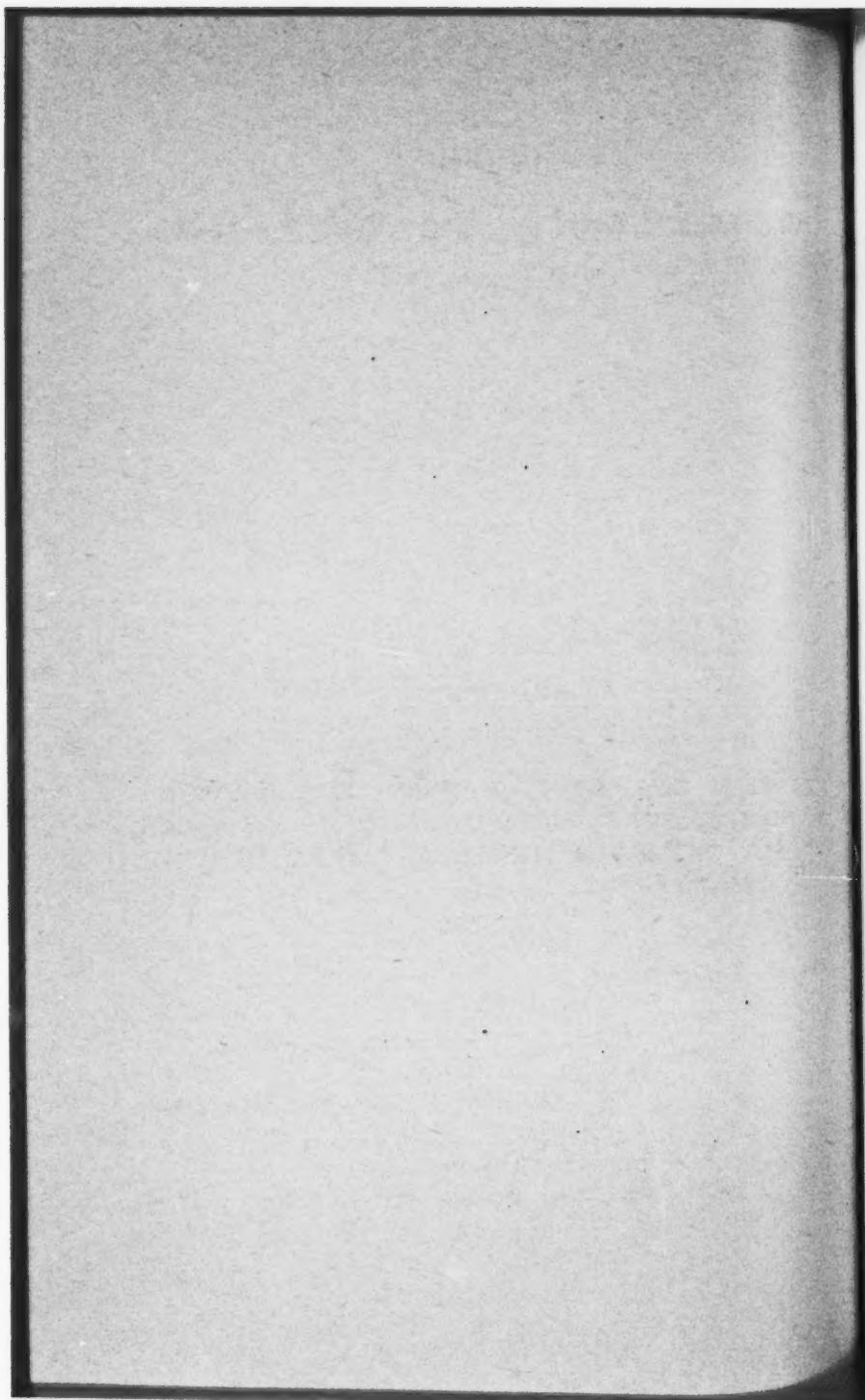
COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SIXTH CIRCUIT AND BRIEF IN SUP-
PORT THEREOF

JOHN J. KENDRICK,
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Of Counsel.



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*To the Honorable the Chief Justice and Associate Justices
of the Supreme Court of the United States:*

Your petitioner, The France Stone Company, respectfully represents and shows to the court:

SUMMARY STATEMENT OF THE CASE

This case involves petitioner's federal income tax liability for the calendar year 1937. The particular type of tax which is the subject of the controversy is the tax commonly known as the undistributed profits tax which was first imposed upon corporations by the Revenue Act of 1936.

Petitioner is an Ohio corporation with its principal place of business at Toledo. It is engaged in the business of crushing stone for railroad ballast, concrete construction, highway building and similar building trades and uses (R. 93). Early in 1933 the taxpayer's capital structure was revised (R. 93). Thereafter the capital structure of petitioner was as follows (R. 94):

- 8,000 shares cumulative preferred stock—non-voting;
- 10,000 shares Class A common stock having a par value of \$100 per share and entitled to a dividend of \$6.00 per share per year—non-voting;
- 10,000 shares no par value Class B common stock which was voting stock. Stated value of the B stock was \$1,000.

The new preferred shares were represented by new certificates and one of the provisions under which said new preferred shares were issued, and which appeared on the preferred stock certificates, was in part as follows (R. 94):

“After providing for the payment of the cumulative dividend then due on the preferred shares and before any dividends are declared, paid or set aside to or for other shareholders, the Directors shall set aside from the remaining surplus earnings for each year a sum equal to 5% of the par value of all of the preferred shares then outstanding, as a Sinking Fund to be held and used for the redemption of the preferred shares as hereinafter provided, and for no other purpose. This Sinking Fund provision shall be cumulative so that if in any year, the surplus earnings of the corporation shall be insufficient for the purpose of setting aside the aforesaid amount so provided for the Sinking Fund, then no dividend shall be paid to, or declared or set aside for, any shareholders other than the preferred shareholders.”

Up to December 31, 1937, dividends were paid annually upon the preferred shares (R. 28).

Dividends of 10 cents a share were paid on the Class

A common stock in 1937, since the corporation desired to continue its dividend record, it having paid a dividend upon its common stock since its beginning (R. 94-95).

No dividends were paid upon the Class B common stock during the year 1937.

The taxpayer sustained net losses for several of the years prior to 1936 and during that time made no provision for meeting its sinking fund requirements with respect to the redemption of its preferred stock. According to the terms and provisions of the preferred stock issue the amounts required to be set aside as a Sinking Fund to be held and used for the redemption of the preferred stock aggregated \$385,000 to January 1, 1937. The amounts actually set aside for the fund up to that date amounted to \$263,000. During 1937 petitioner increased this Sinking Fund by the amount of \$37,000, which brought the total amount actually set aside to \$300,000 as of December 31, 1937 (R. 95-96).

For the calendar year 1937 respondent determined that the correct net income of petitioner for federal income tax purposes was in the amount of \$123,410.20. Respondent also determined that the adjusted net income of petitioner for the purpose of computing the surtax on its undistributed profits for the year 1937 amounted to \$111,379.81. Respondent allowed as a dividends paid credit and as a reduction of said adjusted net income for the purpose of computing petitioner's undistributed profits surtaxes, the sum of \$44,807.50, representing cash dividends paid to petitioner's stockholders during the calendar year 1937 and thus computed an undistributed net income subject to surtaxes of \$66,572.31, with a resulting surtax of \$10,747.62, the amount of the tax deficiency in controversy in the case (R. 9, R. 33, R. 96). Petitioner claims that it is entitled to a credit of \$111,379.81 against its adjusted net income for the purpose of computing surtaxes on undistributed

profits, said credit being computed as follows (R. 28):

Cash dividends paid during 1937.....	\$ 44,807.50
Credit for contracts restricting dividend payments under Section 26(c) (1) of the Revenue Act of 1936.....	66,572.31
	<hr/>
	\$111,379.81

The credit claimed by petitioner of \$66,572.31 under Section 26(c) (1) of the Revenue Act of 1936 was based upon the contract above referred to between petitioner and its preferred shareholders which restricted and prevented petitioner from paying dividends during the year 1937 as hereinbefore specifically set forth. Respondent limited the dividends paid credit to the dividends actually paid by petitioner during the year 1937 and refused to allow any credit on account of petitioner's contract with its preferred shareholders (R. 96).

Petitioner appealed from respondent's determination to the United States Tax Court (formerly United States Board of Tax Appeals) and that court concluded that petitioner's contract with its preferred stockholders did not constitute a contract within the meaning of Section 26(c) (1) of the Revenue Act of 1936 and upheld respondent's determination (R. 98). Petitioner then filed a petition for review with the United States Circuit Court of Appeals for the Sixth Circuit (R. 99) which court on February 9, 1943, affirmed the decision of the United States Tax Court (R. 103 and R. 104).

OPINIONS BELOW

The Circuit Court of Appeals rendered no opinion in this case but merely entered an order of judgment which may be found at page 103 of the record.

The opinion of the United States Tax Court is set forth in the record on page 93.

JURISDICTION

The jurisdiction of this court is invoked under Section 240 of the Judicial Code as amended by the Act of Congress approved February 13, 1925, Chapter 229, Section 1, 43 Stat. 938 (Title 28 United States Code, Section 347).

STATUTE INVOLVED

The case involves the meaning and application of Section 26(e) (1) as amended by Section 501 of the Revenue Act of 1942, which provides in part as follows:

"Sec. 26. Credits of Corporations. In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax— * * *

(e) Contracts Restricting Payment of Dividends.

(1) Prohibition on Payment of Dividends. An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account."

THE QUESTION PRESENTED

Is the contract between petitioner and its preferred shareholders which was entered into by petitioner prior to May 1, 1936, such a contract as is contemplated by Section 26 (e) (1) of the Revenue Act of 1936, as amended by Section 501 of the Revenue Act of 1942, so as to entitle petitioner to a credit of \$66,572.31 against its undistributed net income for 1937?

REASONS RELIED UPON FOR ALLOWANCE OF WRIT OF CERTIORARI

1. The decision of the United States Circuit Court of Appeals is in direct conflict with the decision of the United States Circuit Court of Appeals for the Third Circuit in the case of *Lehigh Structural Steel Company vs. Commissioner* (March 27, 1942), 127 F. 2d 67. The Commissioner of Internal Revenue, respondent herein, filed no petition for writ of certiorari for review of the decision of the Circuit Court of Appeals for the Third Circuit in the Lehigh Structural Steel case.

2. The decision of the United States Circuit Court of Appeals is probably based upon an erroneous interpretation of and is probably in conflict with the rule of law announced by this court in *Helvering vs. Northwest Steel Rolling Mills, Inc.* (1940), 311 U. S. 46, and *Crane-Johnson Company vs. Helvering* (1940), 311 U. S. 54.

3. The decision of the United States Circuit Court of Appeals is in direct conflict with the purpose and intent of the amendments to Section 26 of the Revenue Act of 1936 as enacted by Congress in Section 501 of the Revenue Act of 1942.

4. The precise questions here involved have never been before this court, and in view of the decision of this court in *Helvering vs. Northwest Steel Rolling Mills, Inc., supra*, and in view of the retroactive amendments to the Revenue Act of 1936 by Section 501 of the Revenue Act of 1942, it is submitted that the same are of such general importance that this court should announce the rules of law properly applicable thereto.

WHEREFOR, your petitioner prays that a writ of *certiorari* issue under the seal of this Honorable Court directed to the United States Circuit Court of Appeals for the Sixth Circuit commanding that court to certify and to

send to this court for review a full and complete transcript of the record of the proceedings in cause No. 9774 entitled on its docket "*The France Stone Company, Petitioner, vs. Commissioner of Internal Revenue, Respondent,*" and that said judgment of the United States Circuit Court of Appeals may be reversed by this Honorable Court and that your petitioner may have such other and further relief in the premises as to this Honorable Court may seem proper.

JOHN J. KENDRICK,
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Of Counsel.





IN THE

Supreme Court of the United States

October Term, 1942

No.

THE FRANCE STONE COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

I.

STATEMENT OF THE CASE

Reference is made to the foregoing petition for Summary Statement of the Case, Citation of Opinions Below and Statement as to Jurisdiction.

II.

SPECIFICATIONS AND ASSIGNMENTS OF ERROR

1. The court below erred in affirming and not reversing the judgment of the United States Tax Court for respondent.
2. The court below erred in holding that the contract between petitioner and its preferred shareholders was not such a contract as is contemplated by the provisions of Section 26(c) (1) of the Revenue Act of 1936 as amended by Section 501 of the Revenue Act of 1942.

3. The court below erred in holding that the issue before it was controlled by the rule laid down by this court in the case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, (1940), 311 U. S. 46.

4. The court below erred in refusing to hold that the retroactive amendment to Section 26(c) (1) of the Revenue Act of 1936 enacted by the Congress in Section 501 of the Revenue Act of 1942 enlarged the scope, meaning and application of the provisions of Section 26(c) (1) of the Revenue Act of 1936.

5. The court below erred in not allowing to petitioner the credit amounting to \$66,572.31 claimed by it as a reduction of its undistributed net income for the year 1937 and in refusing to hold that there was no undistributed net income of petitioner subject to surtax under Sections 14(a) (1) and 26(c) (1) of the Revenue Act of 1936 as amended by Section 501 of the Revenue Act of 1942.

III.

SUMMARY OF ARGUMENT

1. The decision of the court below is in direct conflict with the decision of the United States Circuit Court of Appeals for the Third Circuit in the case of *Lehigh Structural Steel Company vs. Commissioner* (1942), 127 F. 2d 67.
2. The decision of the court below is probably based upon an erroneous interpretation of and is probably in conflict with the rule of law announced by this court in the case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, (1940), 311 U. S. 46.
3. The decision of the court below fails to recognize that the retroactive amendments to Section 26 of the Revenue Act of 1936 enacted by the Congress at Section 501 of the Revenue Act of 1942 enlarged the scope, meaning and application of the provisions of Section 26(c) (1) of the Revenue Act of 1936.

IV.

ARGUMENT

1. The Decision of the Court Below Is in Direct Conflict With the Decision of the United States Circuit Court of Appeals for the Third Circuit in the Case of *Lehigh Structural Steel Company vs. Commissioner* (1942), 127 F. 2d 67.

The contract in question between petitioner and its preferred shareholders which was entered into by the parties early in 1933 (R. 27) contained the following provision (R. 43):

“After providing for the payment of the cumulative dividend then due on the preferred shares and before any dividends are declared, paid or set aside to or for other shareholders, the Directors shall set aside from the remaining surplus earnings for each year, a sum equal to five per cent (5%) of the par value of all of the preferred shares then outstanding as a Sinking Fund to be held and used for the redemption of the preferred shares as hereinafter provided, and for no other purpose. This Sinking Fund provision shall be cumulative so that if in any year, the surplus earnings of the corporation shall be insufficient for the purpose of setting aside the aforesaid amount so provided for Sinking Fund, then no dividend shall be paid to, or declared or set aside for any shareholders other than the preferred shareholders.”

To January 1, 1937, the amounts required to be set aside as a Sinking Fund to be held and used for the redemption of preferred stock under the terms and provisions of the preferred stock issue aggregated \$385,000 (R. 28). Owing to net losses in its operations for years prior to 1936 the total amount actually set aside for the sinking fund under petitioner's preferred stock issue up to December 31, 1937, was only \$300,000 which included contributions of \$63,000 during the year 1936 and \$37,000 during

the year 1937 (R. 27 and R. 28). At the end of 1937 petitioner had outstanding \$700,000 par value of its 6% cumulative preferred stock (R. 28). Up to December 31, 1937, dividends were paid annually upon the preferred shares (R. 28). From 1931 through 1937, inclusive, dividends were paid upon the Class A common stock at the rate of ten cents per share, or a total annual payment of \$1,000 (R. 29). This payment was made since the corporation desired to continue the dividend record of the company which had paid a dividend upon its common stock since its beginning (R. 16 and R. 17). No dividends were paid upon the Class B common stock during the year 1937.

On account of its lack of profits out of which such sinking fund provisions might have been made in prior years and on account of the consequent deficiency in the Preferred Stock Sinking Fund petitioner was restricted from paying dividends upon its common stock by the terms and provisions of its contract with its preferred shareholders above referred to. Consequently the petitioner contends that it was entitled to a credit of \$66,572.31 under the provisions of Section 26(c) (1) of the Revenue Act of 1936, *supra*, which would have had the result of eliminating its undistributed profits for the year 1937, thus resulting in no surtax liability for said year. Respondent, the United States Tax Court, and the court below, however, concluded that the contract between petitioner and its preferred shareholders was not such a contract as was contemplated by Section 26(c) (1) of the Revenue Act of 1936. The court below based its conclusion upon the decisions rendered by it in the cases of *Warren Telephone Company vs. Commissioner*, 128 F. 2d 503 (certiorari denied Jan. 11, 1943), and *Metal Specialty Company vs. Commissioner*, 128 F. 2d 259.

The *Metal Specialty Company* case and the *Warren Telephone Company* case were decided in the court below

on the same day (June 2, 1942). On March 27, 1942, the United States Circuit Court of Appeals for the Third Circuit decided the case of *Lehigh Structural Steel Company vs. Commissioner*, 127 F. 2d 67. There the taxpayer was contending that it was entitled to the credit afforded by Section 26(c) (1) of the Revenue Act of 1936 by reason of a provision in its agreement with its preferred shareholders almost identical with the provision in the contract between petitioner and its preferred shareholders which has been hereinbefore quoted. In the *Lehigh Structural Steel Company* case the court decided that the contract between the taxpayer corporation and its preferred shareholders met the statutory test and that therefore the taxpayer was entitled to the credit as claimed under Section 26(c) (1) of the Revenue Act of 1936.

The United States Circuit Court of Appeals for the Sixth Circuit in the *Warren Telephone Company* case recognized that its decision was in conflict with the rationale of the opinion by the Third Circuit Court of Appeals in the *Lehigh Structural Steel Company* case and in that connection made the following statement in its opinion (page 506):

“This view is not in accord with that of the Third Circuit Court of Appeals in *Lehigh Structural Steel Company vs. Commissioner*, 127 F. 2d 67.”

Thus the United States Circuit Court of Appeals for the Sixth Circuit in deciding this case upon the authority of its decision in the *Warren Telephone Company* case, specifically recognizes that its decision in this case is in direct conflict with the decision by the United States Court of Appeals for the Third Circuit in the *Lehigh Structural Steel Company* case.

While *certiorari* was denied in the *Warren Telephone Company* case, it is entirely possible that the denial was due to the fact that the Solicitor General in his memoran-

dum in opposition to the granting of the writ admitted in the footnote at page 9 of his memorandum that the taxpayer, a deficit corporation, was entitled to the benefits afforded by Section 501 of the Revenue Act of 1942, and that a tentative computation resulted in the elimination of the greater portion of the deficiency there involved. Since petitioner here is not a deficit corporation no such relief can be conceded in the instant case.

It might also be well to mention that the Third Circuit Court of Appeals indicated in the case of *Eljer Company vs. Commissioner*, decided on February 24, 1943, and as yet unreported, that its views as announced in the case of *Lehigh Structural Steel Company vs. Commissioner, supra*, have not in any way been modified by the conflicting opinion of the Sixth Circuit in the *Warren Telephone Company* case.

2. The Decision of the Court Below Is Probably Based Upon an Erroneous Interpretation of and Is Probably in Conflict With the Rule of Law Announced by this Court in the Case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, (1940), 311 U. S. 46.

The court below decided the instant case as well as the *Warren Telephone Company* and *Metal Specialty Company* cases upon what it conceived to be the rule laid down by this court in the case of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, 311 U. S. 46, whereas the United States Circuit Court of Appeals for the Third Circuit reached an exactly opposite conclusion in the *Lehigh Structural Steel Company* case upon almost identical facts.

In the case of *Helvering vs. Northwest Steel Rolling Mills, Inc., supra*, it appeared that credit was there claimed under Section 26(c) (1) because (1) of an oral agreement with a bank that all surplus money over and above that

needed for current operating expenses would be applied by the company on its indebtedness to the bank; and (2) because the company had a deficit in capital account and could not therefore declare or pay any dividends under the laws of the State of Washington, the state of its incorporation. This court in interpreting the provisions of Section 26(c) (1) held that Northwest Steel Rolling Mills, Inc., was not entitled to the credit as claimed because the contract was not a written contract executed by the corporation which "expressly deals with the payment of dividends" and refused to approve the taxpayer's attempt to characterize its corporate charter as a contract within the meaning of Section 26(c) (1). In order to emphasize its decision with respect to the taxpayer's contention in the *Northwest Steel Rolling Mills* case, this court proceeded to analyze Section 26(c) (2) of the Revenue Act of 1936. That section (Section 26(c) (2)) gave a similar credit to a corporation which was prevented from paying out its earnings and profits for the taxable year in dividends by the terms and provisions of a written contract entered into by the corporation prior to May 1, 1936, with a creditor of the corporation. This court reached the conclusion that Section 26(c) (1) of the Revenue Act of 1936 should be as strictly construed as Section 26(c) (2) of that Act, since the claimed credit involved a specially permitted deduction.

However, this court did not read into Section 26(c) (1) the provision that a contract in order to come within the provisions of Section 26(c) (1) must be a routine contract with a creditor of the corporation, but the Sixth Circuit Court of Appeals in the *Warren Telephone Company* case, *supra*, thus fell into error. In that case the court wrote into Section 26(c) (1) the additional limitations not contained in the Act, that contracts in order to come within the provisions of Section 26(c) (1) must be "routine contracts dealing with ordinary debts and not to statutory

obligations." Thus the Circuit Court of Appeals for the Sixth Circuit wrote into Section 26(c) (1) two limitations not contained in the Act, namely, (1) that the contract must be a routine contract dealing with ordinary debts and not to statutory obligations; and (2) that the contract must be entered into by the corporation with its creditor, but this court in the *Northwest Steel Rolling Mills* case, *supra*, when it was discussing "debts" and "creditors" in its opinion, was discussing Section 26(c) (2) and not Section 26(c) (1).

The United States Board of Tax Appeals in the case of *Reclaimed Island Lands Company*, 46 B. T. A. 1048-1057, concluded that what this court was pointing out in the *Northwest Steel Rolling Mills* case, *supra*, by use of the expression "routine contracts" was a distinction between contractual obligations and statutory obligations. In that case the Commissioner was attempting to disqualify a contract between a corporation and one of its stockholders who had guaranteed certain of the company's obligations.

The Third Circuit Court of Appeals in the *Lehigh Structural Steel Company* case, *supra*, was not at all disturbed by the expression "routine contracts" as used by this court in the *Northwest Steel Rolling Mills* case. That court reached the unqualified conclusion that a contract between a corporation and its preferred shareholders such as is here involved, is within the application of Section 26(c) (1) of the Revenue Act of 1936. That court concluded that the decision of this court in the *Northwest Steel Rolling Mills* case, *supra*, had reference only to so-called "deficit corporations" or to statutory obligations of a corporation as distinguished from its contractual obligations. Thus the direct conflict arose between the Third Circuit Court of Appeals and the Sixth Circuit Court of Appeals which was expressly recognized by the Sixth Circuit Court of Appeals in its opinion in the *Warren Telephone Company* case.

It is deemed advisable to bring before this court three very significant facts arising out of or related to this conflict of opinion between the Circuit Courts of Appeal with respect to the meaning and significance of the decision of this court in the *Northwest Steel Rolling Mills* case, *supra*, namely:

1. The Commissioner of Internal Revenue sought no writ of *certiorari* to review the decision of the Third Circuit Court of Appeals in the case of *Lehigh Structural Steel Company vs. Commissioner*;

2. The Solicitor General of the United States in his brief on behalf of the Commissioner of Internal Revenue in the case of *Crane-Johnson Company vs. Helvering*, 311 U. S. 54, which was a case exactly like that of *Helvering vs. Northwest Steel Rolling Mills, Inc.*, said on pages 7 and 8:

“Petitioner’s alternative argument, not raised before the Board or properly presented to the court below, that its stock certificates were written contracts executed by it and that the North Dakota statute was a part of such contracts, was untenable. Although stock certificates containing express restrictions against dividend payments would come under Section 26(c) (1), a state law restricting dividend payments, which is at best an implied provision of the stock certificates, does not satisfy the requirements of the section.” (Emphasis ours.)

3. When Warren Telephone Company petitioned this court for a writ of *certiorari* to the United States Circuit Court of Appeals for the Sixth Circuit the Solicitor General of the United States pointed out to this court on page 9 of his memorandum in opposition to the petition that the taxpayer in that case was entitled to certain relief in view of “the relief provisions (retroactive to 1936) with respect to deficit corporations in the Revenue Act of 1942” and conceded that “the question presented by the conflict may become moot in a number of the pending cases.” However, the Solicitor General in his memorandum at page 8 in commenting upon the conflict between the decisions of the Sixth Circuit Court of Appeals in the *Warren Telephone Company*

case and the Third Circuit Court of Appeals in the *Lehigh Structural Steel Company* case conceded that "it would be appropriate for the court to grant *certiorari* in view of the conflict."

Thus it would appear that the only solution to the confusion now existing would be to grant *certiorari* in the instant case so that all doubts with respect to the meaning and significance of this court's opinion in the *Northwest Steel Rolling Mills* case may be forever resolved.

3. The Decision of the Court Below Fails to Recognize That the Retroactive Amendments to Section 26 of the Revenue Act of 1936 Enacted by the Congress at Section 501 of the Revenue Act of 1942 Enlarged the Scope, Meaning and Application of the Provisions of Section 26(c) (1) of the Revenue Act of 1936.

When the Tax Bill of the Revenue Act of 1936 originated in the House of Representatives it was clearly apparent that the House intended that the undistributed profits tax which was new in that Act should be imposed upon those corporations which could but would not pay dividends to their shareholders.¹ The House Bill granted exemptions from the tax to those corporations which could not pay dividends for various reasons. Those exempt corporations might be classified as follows:²

1. Those corporations which were obligated under written contracts entered into prior to May 1, 1936, to refrain from paying dividends during the taxable year.
2. Those corporations which were obligated under written contracts entered into prior to May 1, 1936, to apply

¹See the Report of Hearings before the Committee on Ways and Means of the House of Representatives re Revenue Act of 1936, 74th Congress, Second Session, pages 14 to 26.

²See H. R. 12395, 74th Congress, Second Session, Sections 14, 15 and 16; H. Rep. No. 2475, 74th Congress, Second Session, pp. 8-9.

their earnings for the taxable year in the reduction of indebtedness due and owing to a creditor.

3. So-called deficit corporations which were prevented from paying dividends during the taxable year by some statutory requirement of the state of their incorporation.

That the House of Representatives intended to include as a contract within the application of the first exemption a contract between a corporation and its preferred shareholders, as is here involved, is unrefutably demonstrated by the colloquy reported at pages 61 and 62 of the Hearings before the Committee on Ways and Means of the House of Representatives, 74th Congress, Second Session, where such contracts as here involved were expressly designated as being within the exemption.

When the Bill reached the Senate, the Senate Finance Committee deleted the third exemption hereinabove referred to and thus the Bill was finally passed by the Congress. It was to some extent on account of this deletion of the third exemption enumerated above that this court in the case of *Helvering vs. Northwest Steel Rolling Mills*, *supra*, reached the conclusion that the taxpayer there involved, a so-called deficit corporation, was not entitled to the credit claimed against undistributed income subject to the levy of the undistributed profits tax. After the decision by this court in the *Northwest Steel Rolling Mills* case, *supra*, Congress in enacting the Revenue Act of 1942, at Section 501 thereof, retroactively restored the exemption to deficit corporations which were prevented from paying dividends during the taxable year by some statutory requirement of the state of their incorporation.

While petitioner contends that the deletion by the Senate of the exemption for deficit corporations in the course of the enactment of the Revenue Act of 1936 in no wise affected the exemption afforded by Section 26(e) (1) of the Act, namely, to corporations which were contrac-

tually obligated prior to May 1, 1936, to refrain from paying dividends during the taxable year, yet if it can be said that the deletion by the Senate of the third exemption in any way narrowed the application of the first exemption, petitioner now contends that the retroactive restoration of the third exemption by Section 501 of the Revenue Act of 1942 completely restores the aim and purpose of the undistributed profits tax of the Revenue Act of 1936 as it originated in the House of Representatives. That aim and purpose, as has been hereinbefore stated, was to impose the surtax upon those corporations which could but would not pay dividends to their shareholders during the taxable year. Petitioner submits that it was contractually obligated under the terms and provisions of its contract with its preferred shareholders to refrain from paying dividends to its common stockholders in the year 1937 and that therefore it could not pay any dividends in addition to those which it paid to its preferred shareholders. Thus petitioner claims it is entitled to the credit afforded by Section 26(c) (1) of the Revenue Act of 1936 as amended by Section 501 of the Revenue Act of 1942.

It is therefore submitted that the writ of *certiorari* should be allowed as prayed for and that the judgment of the court below should be reversed.

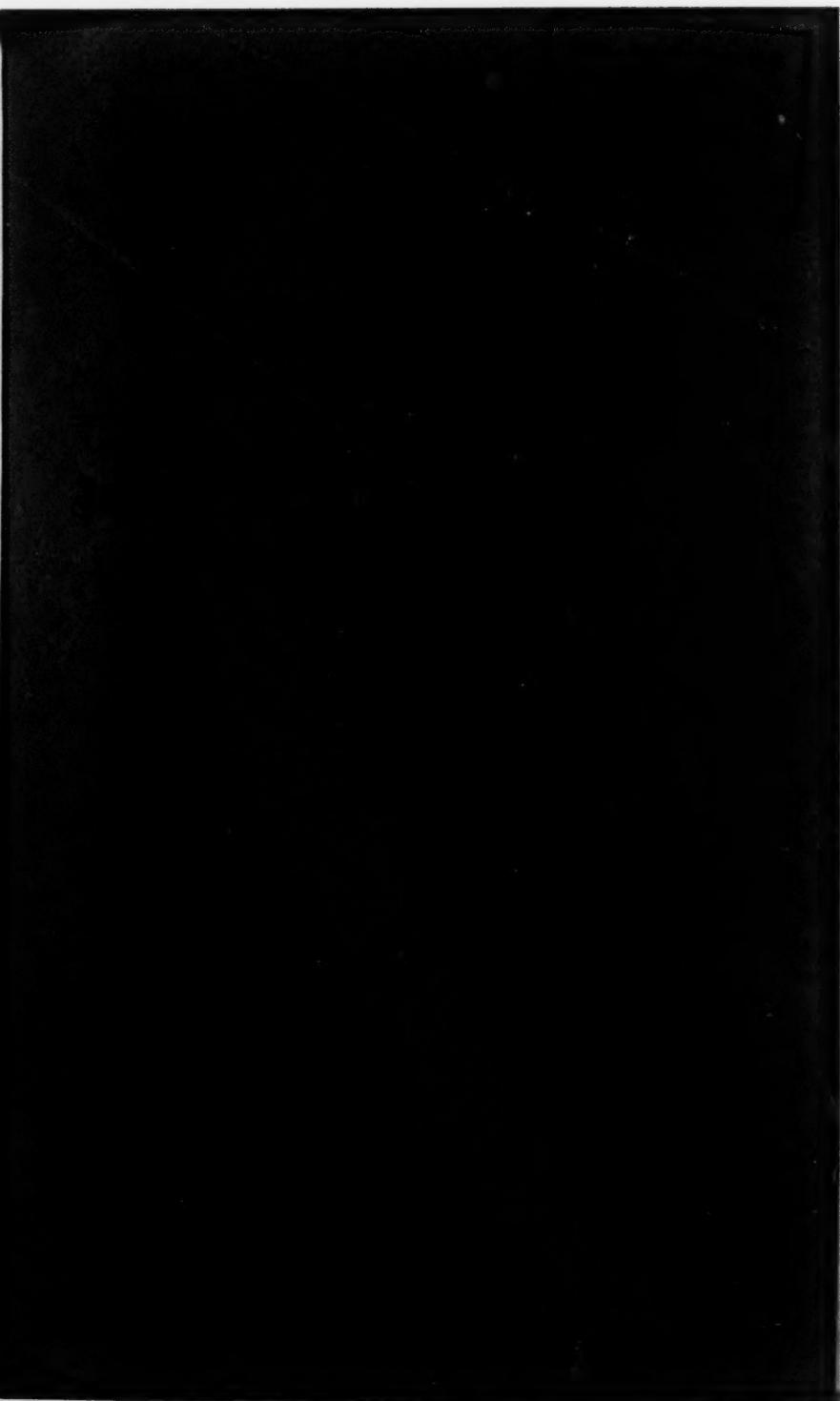
Respectfully submitted,

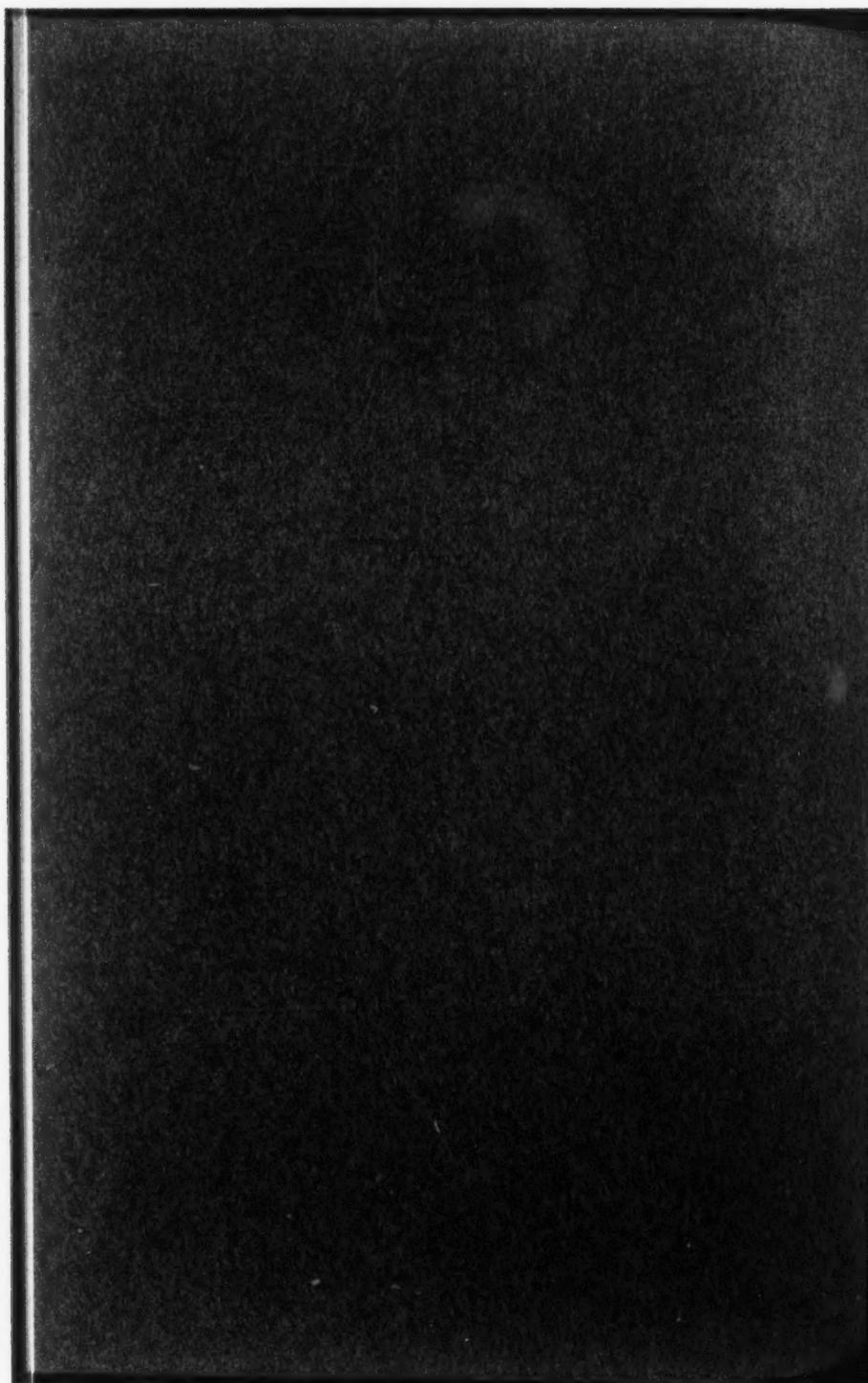
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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 857

THE FRANCE STONE COMPANY, PETITIONER

v.

**GUY T. HELVERING, COMMISSIONER OF INTERNAL
REVENUE**

**ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH
CIRCUIT**

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 93-98) is not officially reported. The Circuit Court of Appeals promulgated no formal opinion, but expressed its views in its judgment (R. 103-104), which is not reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 9, 1943 (R. 103-104). The petition for a writ of certiorari was filed on

(1)

March 27, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

Whether taxpayer's preferred stock certificates constituted contracts prohibiting the payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, so as to entitle it to a credit thereunder in computing its undistributed net income.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 10-15.

STATEMENT

The material facts as found by the Board of Tax Appeals (R. 93-97) from a stipulation by the parties (R. 26-29) may be summarized as follows:

Petitioner is an Ohio corporation with its principal place of business at Toledo. It is engaged in the business of crushing stone for railroad ballast, concrete construction, highway building, and similar uses. (R. 93.)

Early in 1933 petitioner's capital structure was revised, and thereafter was as follows (R. 94):

8,000 shares cumulative preferred stock—nonvoting;

10,000 shares class A common stock having a par value of \$100 per share and entitled to a dividend of \$6 per share per year—nonvoting;

10,000 shares no par value class B common stock which was voting stock. Stated value of the B stock was \$1,000.

The new preferred shares were represented by new certificates, and one of the provisions under which such new preferred shares were issued, and which appeared on the preferred stock certificates, was in part as follows (R. 94):

After providing for the payment of the cumulative dividend then due on the preferred shares, and before any dividends are declared, paid or set aside to or for other shareholders, the Directors shall set aside from the remaining surplus earnings for each year, a sum equal to five percent (5%) of the par value of all of the preferred shares then outstanding, as a Sinking Fund to be held and used for the redemption of the preferred shares as hereinafter provided, and for no other purpose. This Sinking Fund provision shall be cumulative so that if in any year, the surplus earnings of the corporation shall be insufficient for the purpose of setting aside the aforesaid amount so provided for sinking fund, then no dividend shall be paid to, or declared or set aside for, any shareholders other than the preferred shareholders.

Up to December 31, 1937, dividends were paid annually on the preferred shares. Dividends of 10 cents a share were paid on the class A common stock from 1931 through 1937, inclusive, since the petitioner desired to continue its dividend record,

having paid a dividend upon its common stock since its beginning. (R. 94-95.)

Petitioner sustained net losses for each of the years 1932 through 1935, and during that time made no provision for meeting its sinking-fund requirements with reference to the redemption of the preferred stock. During 1936 it made provision for increasing this sinking fund in the amount of \$63,000 and paid this amount to the trustee for redemption or retirement of its preferred stock. During 1937 petitioner increased this sinking fund in the amount of \$37,000. At the end of 1937 petitioner had outstanding \$700,000 par value of the 6% cumulative preferred stock. According to the revised articles of incorporation printed on the reverse side of its certificates of the preferred stock, the amounts required to be set aside as a sinking fund to be held and used for the redemption of the preferred stock aggregated \$385,000 to January 1, 1937. The amounts actually set aside for the fund up to that date amounted to \$263,000. The amount of \$37,000 added to the fund during 1937 brought the total amount actually set aside to \$300,000 as of December 31, 1937. (R. 95-97.)

Petitioner's balance sheet at the close of 1937 showed total assets of \$2,479,345.30, capital stock liabilities of \$1,701,000, and earned surplus of \$658,356.71 (R. 96-97).

On its return for 1937 the petitioner, in computing its undistributed profits surtax, claimed a

dividends paid credit of \$46,099.14 on account of dividends stated to have actually been paid in cash during the taxable year, and also claimed a credit for contracts restricting dividend payments in the amount of \$60,977.05, which was less than \$121,850, the cumulative deficiency in its sinking fund as of December 31, 1937. (R. 96.)

In the notice of deficiency the Commissioner allowed a dividends paid credit of \$44,807.50, which amount is equal to the cash dividends paid during the year 1937, and disallowed the amount of \$1,291.64, which represented a dividend carry-over from the preceding taxable year. The Commissioner also disallowed the claimed credit for contracts restricting dividend payments in the amount of \$60,977.05 (R. 96).

The petitioner reported a net income for 1937 of \$118,347.12. The Commissioner determined that the correct adjusted net income was in the amount of \$123,410.20. He also determined an adjusted net income for surtax computation in the amount of \$111,379.81, and an undistributed net income of \$66,572.31, which resulted in a surtax on undistributed net income of \$10,747.62, the amount of the deficiency in controversy (R. 96).

The Board of Tax Appeals sustained the Commissioner's determination of the deficiency, and held that petitioner's preferred stock certificates were not "contracts" within the meaning of Section 26 (e) (1) of the Revenue Act of 1936. The Circuit Court of Appeals for the Fifth Circuit

affirmed the judgment of the Board of Tax Appeals.

ARGUMENT

The court below ruled that petitioner was not entitled to the credit claimed because the preferred stock certificates were not "contracts" within the meaning of Section 26 (e) (1) of the Revenue Act of 1936. The court thus followed the view which it had previously expressed in *Warren Telephone Co. v. Commissioner*, 128 F. 2d 503, certiorari denied, No. 550, this Term, and *Metal Specialty Co. v. Commissioner*, 128 F. 2d 259,¹ that upon the general theory of *Helvering v. Northwest Steel Mills*, 311 U. S. 46, the word "contract" in Section 26 (e) (1) was intended to refer to ordinary contracts entered into by the corporation with its creditors, and not to internal agreements within the corporate framework such as those involved in the charter and stock certificates here. In reaching that result the court differed with *Lehigh Structural S. Co. v. Commissioner*, 127 F. 2d 67 (C. C. A. 3d), which held that such agreements were "contracts" within the meaning of Section 26 (e) (1).

The *Warren Telephone Co.* case was similarly in conflict with the *Lehigh* case, but this Court denied certiorari presumably on the ground sug-

¹ See also *Bishop & Babcock Mfg. Co. v. Commissioner*, 133 F. 2d 199 (C. C. A. 6th).

gested by the Government that the decision was in any event correct for reasons unconnected with the issue in the *Lehigh* case. Similarly here, certiorari is not called for, since the decision reached below is clearly correct on grounds not touching the issue involved in the conflict with the *Lehigh* case. For even if the stock certificates be regarded as "contracts" within the meaning of Section 26 (c) (1), petitioner still would not be entitled to any credit under this section because the amount of dividends which it could have distributed during 1937 without violating those "contracts" exceeded its adjusted net income for that year. The preferred-stock certificates merely provided that before any dividends could be paid on any stock other than the preferred stock, a sum equal to five percent of the par value of the outstanding preferred stock should be set aside from the surplus earnings of each year. But petitioner's earned surplus at the end of 1937 amounted to \$658,356.71. Its adjusted net income for 1937 was \$111,379.81. The current preferred dividend requirement for 1937 had been paid, and even after deducting from petitioner's earned surplus the total cumulative arrearages in the sinking fund, amounting to \$121,850, there was a remaining surplus exceeding \$500,000 from which dividends might have been paid. The payment of such dividends would have entitled petitioner to a

dividends-paid credit under Section 27 (a). Failure to pay them was not mandatory under the "contracts," so the credit was not allowable.² Accordingly, the result below is correct irrespective of the issue whether the stock certificates are "contracts" within the meaning of Section 26 (c) (1).

Furthermore, the issue cannot arise for future tax years, and, in view of the relief provisions (retroactive to 1936) with respect to deficit corporations in the Revenue Act of 1942,³ the question presented by the conflict with the *Lehigh* case may become moot in many of the pending cases.

CONCLUSION

The result reached by the court below is correct. The issue raised by petitioner presents no question of such general importance as would warrant

² Surplus, as well as current earnings, are to be taken into account under the statute in determining the total amounts which can be distributed as dividends. *L. O. Kovén & Brother, Inc. v. Commissioner*, 47 B. T. A. 467, 471, affirmed January 11, 1943 (C. C. A. 3d) (1943 C. C. H., par. 9244); *Trianon Hotel Co. v. Commissioner*, 44 B. T. A. 1073; *Monroe Abstract Corp. v. Commissioner*, 41 B. T. A. 5; see also *Central West Coal Co. v. Commissioner*, 44 B. T. A. 661, 669, affirmed, 132 F. 2d 190 (C. C. A. 7th).

³ Section 501 (a) (3) of the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess. (Appendix, *infra*, pp. 11-12) amends the Revenue Act of 1936 and allows additional credits in the case of deficit corporations. It in nowise affects the applicability of Section 26 (c) (1) of the Revenue Act of 1936 to nondeficit corporations, as in the case of petitioner here.

further review by this Court. We submit that the petition should be denied.

Respectfully submitted.

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SEWALL KEY,
ARTHUR MANELLA,

Special Assistants to the Attorney General.

APRIL 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of

a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess.:

SEC. 501. ADDITIONAL CREDITS FOR UNDISTRIBUTED PROFITS TAX.

(a) *Amendments to the Revenue Act of 1936.—*

(1) Section 14 (a) (2) of the Revenue Act of 1936 (relating to definition of undistributed net income) is amended to read as follows:

"(2) The term 'undistributed net income' means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g)."

(2) Section 26 (e) of the Revenue Act of 1936 (relating to credits of corporations) is amended by amending the heading to read as follows: "(e) *Restrictions on Payment of Dividends.—*"; and by amending paragraph (3) to read as follows:

"(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumu-

lated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

"(4) *Double credit not allowed.*—If more than one of the credits provided in the foregoing paragraphs (1), (2), and (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

(3) Section 26 of the Revenue Act of 1936 (relating to credits of corporations) is amended by adding at the end thereof the following new subsections:

"(f) *Deficit Credit.*—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103, or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax

as computed under the amendments made by section 501 of the Revenue Act of 1942.

* * * * *

(b) *Effective Date of Amendments.*—The amendments made by subsection (a) shall be effective as of the date of the enactment of the Revenue Act of 1936.

(c) *Overpayments.*—If the refund or credit of any overpayment for any taxable year, to the extent resulting from the application of this section, is prevented on the date of the enactment of this Act or within one year from such date, then, notwithstanding any other provision of law or rule of law (other than this subsection and other than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected under the Revenue Act of 1936, if claim therefor is filed within one year from the date of the enactment of this Act.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (e) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written

contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both sections 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as divi-

dends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

* * * * *